

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED] TL-N-1595-99
[REDACTED]

date: **APR 16 1999**

to: Examination Division, [REDACTED]
ATTN: [REDACTED]

from: Associate District Counsel, [REDACTED]

subject: [REDACTED] – Advance Payments

This memorandum responds to your request for advice regarding the proper treatment of advance payments received by [REDACTED] or the “Taxpayer”) during the years ending January 31, [REDACTED], [REDACTED], and [REDACTED].

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether the Taxpayer is entitled to defer advance payments pursuant to Revenue Procedure 71-21, where it uses an accrual method of accounting under which it includes income from contracts, other than long-term contracts, in its gross income when it has the right to bill for such income under the contract.
2. Whether the Taxpayer is entitled to defer advance payments pursuant to Revenue Procedure 71-21, where:
 - a. the term of the contract exceeds two years, but
 - b. the services to be performed for which the advance payment is made are performed before the end of the taxable year following the year in which the Taxpayer receives the advance payment.
3. Whether the Taxpayer is entitled to defer advance payments pursuant to Revenue Procedure 71-21, where:
 - a. the agreement does not specify when the services are to be performed, but
 - b. the services are performed before the end of the taxable year following the year in which the Taxpayer receives the advance payment.

CONCLUSIONS

1. Yes. Revenue Procedure 71-21 allows an accrual method taxpayer, in certain specified and limited circumstances, to defer the inclusion in gross income of payments received, or amounts due and payable. The Taxpayer is an accrual method taxpayer. The Taxpayer, therefore, is entitled to the benefits of Revenue Procedure 71-21, if it meets the specific requirements of Revenue Procedure 71-21.
2. No. Revenue Procedure 71-21 applies only if the agreement under which the accrual method taxpayer performs its services requires the accrual method taxpayer to perform its services before the end of the taxable year following the year of receipt. In this case, the Taxpayer enters into contracts whose duration exceed two years. Because the contracts exceed two years, they do not satisfy the requirement set forth in Revenue Procedure 71-21.

As a general proposition, the Service should look at each contract as a whole for purposes of determining whether Revenue Procedure 71-21 applies and should not try to find an "agreement" (as that term is used in Revenue Procedure 71-21) within the contract. Nonetheless, the Service should recognize that the Taxpayer may have an argument for treating certain portions of the contract as separate "agreements" for purposes of Revenue Procedure 71-21, where such portions represent separate and distinct services, which if separated from the other services, could stand alone in a separate contract.

3. No. The agreement must specify that all of the services be performed before the end of the next succeeding taxable year. If it does not, it cannot satisfy the requirements of Revenue Procedure 71-21. The Service, however, should keep in mind that the term "agreement," as used in Revenue Procedure 71-21, includes both written and oral agreements. As such, the written contract need not specify the time period for which services are to be performed, as long as the Taxpayer can represent that, under the agreement as a whole, the period for which services are to be performed does not exceed the period prescribed by Revenue Procedure 71-21.

FACTS

The Taxpayer is a Delaware corporation in the business of providing diversified professional technical services and high-technology products to various departments and agencies of the United States government, as well as foreign governments and commercial customers.

The Taxpayer performs its services under four different types of contracts: (1) cost-reimbursement contracts, (2) time-and-materials contracts, (3) fixed-price-level-of-effort contracts, and (4) firm-fixed-price contracts. Under cost-reimbursement contracts, the Taxpayer is reimbursed for its allowable costs plus a fixed fee. Under time-and-materials contracts, the Taxpayer is paid for labor costs at negotiated hourly rates and reimbursed for other allowable costs. Under the fixed-price-level-of-effort contracts, the Taxpayer is paid for labor costs up to an agreed upon maximum and reimbursed for other allowable costs. Under the firm-fixed-price contracts, the Taxpayer receives a fixed fee for its services.

The Taxpayer uses an accrual method of accounting under which it accrues costs at the time it incurs them and income at the time it has the right to bill, or actually bills, the customer for such income (the "right-to-bill method of accounting").

During the years at issue, the Taxpayer received "advance payments" under several contracts. The Taxpayer defines the term "advance payments" as any payment received before any work under the contract is performed. The Taxpayer did not include any "advance payments" in its income for either tax or book purposes. For fiscal years ending December 31, [REDACTED], [REDACTED], and [REDACTED], the Taxpayer excluded the following advance payments from taxable income:

	<u>[REDACTED]</u>	<u>[REDACTED]</u>	<u>[REDACTED]</u>
Advance Payment	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]

During the years at issue, the Taxpayer also received payments under the contracts which were made with respect to services yet to be performed but after services under the contract had started. The Taxpayer included these payments in its income for tax and book purposes.

The Service provided portions of two contracts for us to examine in analyzing the issues presented. Below, we outline the relevant provisions of each contract.

Contract between [REDACTED] and [REDACTED]
(the "[REDACTED] Contract")

On [REDACTED], [REDACTED] entered into the [REDACTED] Contract with the Taxpayer for the purpose of purchasing from the Taxpayer one [REDACTED].

The Taxpayer was required to deliver to [REDACTED] on a firm-fixed-price basis "the [REDACTED] system comprised of a [REDACTED], [REDACTED], [REDACTED] in accordance with paragraph [REDACTED] at Appendix [REDACTED]." Appendix [REDACTED] is entitled "[REDACTED]" and includes the procurement requirements for [REDACTED], [REDACTED]. Appendix [REDACTED] was not included with the portion of the [REDACTED] Contract provided by the Service. The Taxpayer also was required to provide to [REDACTED] on a time-and-material price basis hardware replacement parts for any [REDACTED] and [REDACTED] non-functioning [REDACTED] components.

As stated in the [REDACTED], the price for the [REDACTED] Program was \$ [REDACTED]. The price consists of (1) \$ [REDACTED] "for [REDACTED] as defined in Appendix [REDACTED]" (2) \$ [REDACTED] "in [REDACTED] Commission," and (3) \$ [REDACTED] "pool to be allocated for payment of interest expense and yet to be defined expenses." The payment terms were set as follows:

<u>Payment</u>	<u>Milestone</u>	<u>Amount</u>
I	Contract Award Payment I is due and payable on or before [REDACTED], at its discretion, may delay performance and delivery on a day for day basis, beginning [REDACTED], until this payment is received.	\$ [REDACTED]
II	[REDACTED] Payment II is due and payable on or before [REDACTED], at its discretion, may delay performance and delivery on a day for day basis, beginning [REDACTED], until this payment is received.	\$ [REDACTED]
III	[REDACTED] Payment III is due and payable on or before [REDACTED], at its discretion, may delay performance and delivery on a day for day basis, beginning [REDACTED], until this payment is received.	\$ [REDACTED]

<u>Payment</u>	<u>Milestone</u>	<u>Amount</u>
IV	Document of Transfer — [REDACTED] Installation pending receipt of final payment	\$ [REDACTED]
V	Reserve Pool expense, at price, as agreed by parties	\$ [REDACTED]
VI	Commission paid to [REDACTED]	\$ [REDACTED]
	Total Contract Value	\$ [REDACTED]

Contract between the [REDACTED] and [REDACTED] (the "[REDACTED] Contract")

The [REDACTED] was the recipient of a "cooperative agreement" issued by the [REDACTED] for the conduct of work entitled "[REDACTED]". The cooperative agreement supports the multinational collaborative effort between the [REDACTED], the [REDACTED] Community and the [REDACTED] to conduct the [REDACTED] for the [REDACTED] (" [REDACTED]"), including design, engineering, research, development and testing of scalable models. The [REDACTED] engaged the Taxpayer to participate in this work. And, on [REDACTED], the parties entered the [REDACTED] Contract.

Pursuant to the [REDACTED] Contract, the Taxpayer was required to provide "the necessary personnel, equipment, supplies, services, management, labor, facilities, materials and reports . . . and do all things necessary or incidental to accomplish the works and provide and perform tasks set forth in [REDACTED]". The Taxpayer was required to provide these services for the period from [REDACTED], through [REDACTED].

The Taxpayer performed its services under the [REDACTED] Contract on a cost-plus-fixed-fee basis, not to exceed \$ [REDACTED], as follows:

<u>Period</u>	<u>Cost</u>	<u>FCCM</u>	<u>Fixed Fee</u>	<u>Total</u>
Year [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]
Year [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Year [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Year [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Year [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED]

The [REDACTED] Contract authorized advance payment for periods of approximately one month. The Taxpayer was required to provide the [REDACTED], at least [REDACTED] day prior to the required date for each advance payment, a projected expenditure report for the designated month or extended period. The Taxpayer also was required to submit invoices or vouchers for reimbursement monthly to the [REDACTED].

DISCUSSION

Under I.R.C. § 451, the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used by the taxpayer, such amount is properly accounted for in a different taxable period. Under an accrual method of accounting, income is includible in income when (1) all the events have occurred which fix the right to receive such income and (2) the amount of such income is determinable with reasonable accuracy. Treas. Reg. § 1.451-1(a).

In this case, the Taxpayer uses an accrual method of accounting under which it includes amounts in income at the time it has the right to bill for such amounts. According to the Taxpayer, it rarely receives a payment from a customer before it issues a bill to that customer. Therefore, the Taxpayer's right to receive the income is fixed before the date that it receives the payment. As a consequence, under its method of accounting, the Taxpayer may include the amount in income in a taxable year prior to the year in which it receives payment.

Revenue Procedure 71-21, however, allows, in certain specified and limited circumstances, accrual method taxpayers to defer the inclusion in gross income of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year. Rev. Proc. 71-21, 1971-2 C.B. 549, § 1.

.02 An accrual method taxpayer who, pursuant to an agreement (written or otherwise), receives a payment in one taxable year for services, where all of the services under such agreement are required by the agreement as it exists at the end of the taxable year of receipt to be performed by him before the end of the next succeeding taxable year, may include such payment in gross income as earned through the performance of the services, . . .

.03 . . . [A] payment received by an accrual method taxpayer pursuant to an agreement for the performance by him of services must be included in his gross income in the taxable year of receipt if under the terms of the agreement as it exists at the end of such year:

(a) Any portion of the services is to be performed by him after the end of the taxable year immediately succeeding the year of receipt; or

(b) Any portion of the services is to be performed by him at an unspecified future date which may be after the end of the taxable year immediately succeeding the year of receipt.

Id. §§ 3.02 and 3.03. The key to Revenue Procedure 71-21, therefore, is the existence of an agreement providing for the completion of all services under the agreement on or before the end of the taxable year following the year of receipt.

In this case, the Taxpayer is an accrual method taxpayer. As such, it is the type of taxpayer for which Revenue Procedure 71-21 was promulgated.

The Service, however, argues that the right-to-bill method of accounting used by the Taxpayer places it in a unique position. Specifically, the Service states:

The taxpayer's approved accounting method requires that income be reported when it becomes billable. On the other hand, the straight accrual method of accounting allows for the possibility that a taxpayer may receive an advance cash payment ahead of the time that income might normally be reported. . . . It is the examiner's opinion that the right to bill method of accounting places the taxpayer in the unique position that an authorized billing even though in advance of work being performed must be reported, and the fact that an advance payment is received later, in response to the advance billing, has no [bearing] on its reportability. The conclusion is that the taxpayer should not be allowed to defer income on an advance payment that would normally be reported sooner (advance billing date) under its right to bill method of accounting. . . . The taxpayer's method of accounting requires that the advance payment be included in income at an earlier time than when it is received that because the Taxpayer uses a right-to-bill method of accounting, Revenue Procedure 71-21 does not apply to it.

See Request for Advice, Analysis, ¶ 4.

We disagree with the Service's position. Revenue Procedure 71-21 addresses not only payments received for services to be performed in the following taxable year but also amounts due and payable for such services. Amounts due and payable are treated, for purposes of Revenue Procedure 71-21, as payments received. Rev. Proc. 71-21 at § 1. As a consequence,

when the Taxpayer has a right to bill the income for services to be performed under a contract, the Taxpayer has received an advance payment for purposes of Revenue Procedure 71-21. Therefore, the Taxpayer is eligible to defer the inclusion in gross income of payments received, or amounts due and payable, attributable to services to be performed in the following taxable year, pursuant to Revenue Procedure 71-21.

In this case, however, the Taxpayer does not meet the specific requirements of Revenue Procedure 71-21 and may not defer the inclusion in income of payments received in advance of performing any services under a contract. Revenue Procedure 71-21 specifically precludes the deferral of income in situations where, under the terms of the agreement, any portion of the services to be performed under the agreement are to be performed after the end of the taxable year following the year of receipt. Rev. Proc. 71-21 at § 3.03. The terms of the [REDACTED] Contract and the [REDACTED] Contract extended beyond the taxable year following the year in which the Taxpayer received the "advance payment." For example, the [REDACTED] Contract was executed on [REDACTED], and identified the completion date as [REDACTED].¹ See [REDACTED] Contract, Appendix [REDACTED] Schedule.

Arguably, the Taxpayer should be entitled to defer the inclusion in income of advance payments received at the start of its contracts with [REDACTED] and the [REDACTED], if it can associate these advance payments with services to be performed by the end of the next taxable year. The Taxpayer, however, has not met the "certain specified and limited circumstances" described in Revenue Procedure 71-21 and is not entitled to defer such income. That is, it is not sufficient that the services for which the advance payment is made are performed before the end of the next taxable year. The services must be performed pursuant to an agreement that requires that all of the services to be performed under the agreement be performed by the end of the next taxable year. The situation described above does not meet this criterion.

The Service wonders what constitutes an "agreement" for purposes of Revenue Procedure 71-21. We believe, that, as a general proposition, the term "agreement" will refer to the entire written contract, where a written contract exists. We recognize, however, that the Taxpayer could present a credible argument for treating portions of a contract as separate agreements, where the services to be performed pursuant to these portions represent distinct services, which are not dependent on the other services to be performed pursuant to the contract. For example, the Taxpayer enters into a contract with [REDACTED] in which it agrees (1) to provide maintenance support for two years for a [REDACTED] already developed by it for [REDACTED] and (2) to develop a second [REDACTED] for [REDACTED] within a four-year period. Arguably, although part of one contract, the agreement relating to maintenance support is a

¹ The completion date is identified as 45 Months After Contract ("MAC"). The schedule also identifies other dates that may be of importance, including: (1) "Acceptance Testing," 28 MAC, or [REDACTED], and (2) "Execution of Document of Transfer," 32 MAC, or [REDACTED]. See [REDACTED] Contract, Appendix [REDACTED] Schedule.

separate and distinct agreement from the agreement to develop a new system and should be treated separately for purposes of Revenue Procedure 71-21.

(b)(5)(AC)

1. (b)(5)(AC)
2. [REDACTED]
3. [REDACTED]
4. [REDACTED]

(b)(5)(AC)

The Service also asks whether a taxpayer is entitled to the benefits of Revenue Procedure 71-21 in the situation where the agreement does not specify when the services are to be performed but the taxpayer performs the services by the end of the taxable year following the year of payment. As stated above, the agreement must specify that all of the services under the agreement be performed before the end of the taxable year following the year of payment. If it does not, it does not satisfy the specific requirements of Revenue Procedure 71-21. The Service, however, should keep in mind that the term "agreement" does not just include written agreements. It refers to both written and oral agreements. The Service, therefore, needs to look at the written agreement, as well as any oral agreements, to determine whether the "agreement" specifies when the services are to be performed.

As a final note, the Taxpayer appears to be treating the payments received prior to performing services inconsistently. That is, the Taxpayer does not include the payment if it receives the payment before it performs any services under the contract, but does include the payment if it already has performed some services under the contract. We do not understand the distinction that the Taxpayer has made and submit that the Taxpayer does not have any basis for treating these payments differently.

If you have any questions, please call the undersigned at [REDACTED]

[REDACTED]
Assistant District Counsel

By: [REDACTED]

Attorney